FYTOKEM

2005 ANNUAL REPORT

TABLE OF CONTENTS

Corporate Profile
-1-

President's Message
-2-

Management's Discussion & Analysis of Financial Condition and Results of Operations
-4-

Management's Responsibilities for Financial Reporting
-8-

Auditors' Report
-8-

Statements of (Loss) Income & Deficit
-9-

Balance Sheets
-10-

Statements of Cash Flows
-11-

Notes to Financial Statements
-12-

Shareholder Information
-20-

CORPORATE PROFILE

Fytokem Products Inc. develops and delivers proven natural ingredients to leading formulators in the personal care, nutraceutical and pharmaceutical industries.

Founded in 1994, the Company has conducted discovery research on approximately 400 different plants, all native to Western Canada. This research has applied modern scientific techniques to verify the therapeutic benefits of native plants reported in folklore and "old wives tales".

From this discovery research, the Company found a group of products demonstrating strong efficacies and developed from this group two multi-functional plant extracts for commercial development. These products are currently gaining market acceptance as active ingredients mainly in cosmetic products. In addition, the Company continues to do development work on improving and enhancing the existing products and researching the next round of active ingredients.

The first product, Canadian Willowherb™, has demonstrated efficacy primarily as an anti-irritant, anti-oxidant, anti-inflammatory and anti-bacterial ingredient useful in topical and possibly internal applications. It has gained market acceptance in the personal care industry mainly as an anti-irritant and anti-oxidant. It is used globally in about 370 different cosmetic products including a baby-wipe marketed by Johnson & Johnson, under its own brand name in some countries and under the Penaten brand in others, including Canada. Advertising for this particular product highlights the willowherb content. These wipes were recently voted 2006 Product of the Year in the baby category by the readers of Marketing magazine in the UK.

The second product line, Tyrostat™, is a multi-functional ingredient with demonstrated efficacy as a tyrosinase inhibitor (skin-lightener), anti-oxidant and anti-irritant. Tyrostat™ is marketed globally as a skin-lightening ingredient and is currently used in about 70 different cosmetic products, as well as Claripel Crème, a prescription-only skin-lightener produced and marketed in the USA by Stiefel Laboratories, a leading pharmaceutical manufacturer. Skin-lightening is one of the fastest growing segments of the cosmetic industry. Although the skin-lightening market is focused in Europe and Asia, products that use Tyrostat™ as an active ingredient are available globally.

The Company is currently seeking approval from the Indian Drug Authority for the use of both Canadian Willowherb™ and Tyrostat™ as active pharmaceutical ingredients in India.

Corporate growth will come from three growth areas. Firstly, growth in sales of existing products within existing target customers. Revenue generated from this sales growth will be used to finance the pursuit of growth in two other areas, "homerun" sales to major customers with high volume potential for existing products and the development and marketing of new products. The first phase of this growth is becoming a reality.

WE MAKE THE PRODUCTS YOU USE BETTER - NATURALLY!

PRESIDENT'S MESSAGE










Over ten years ago Fytokem was incorporated based on the concept of developing commercially viable and effective products from naturally occurring active ingredients, unique to the hardy, native plants found in Western Canada. Initially, we did efficacy testing on hundreds of native plants, screened these for functional activity, developed processes for extracting active compounds, and started to commercialize several novel ingredients that are now used regularly in consumer products around the world. This early foundation work is now starting to pay dividends.

We've listened to our customers and we've worked hard to respond to feedback from the marketplace. We've improved the color of our products, improved the lot-to-lot consistency, conducted tests to confirm product safety, and developed new product formats in response to customer feedback. More recently we have spent a lot of time and effort improving our existing products, ensuring the initial work can be confirmed, and improving our quality control systems while controlling our expenditures in all areas. These efforts take time, and money. We've been patient, and we are now starting to see the results of these efforts.

The cosmetics market continues to be our market entry point. In many cases, particularly with industry leaders, evaluation of new actives and decisions regarding their use can take what seems to us a painfully long time. In some cases we know that our active ingredients have been under consideration since the late 1990's. In one case, a major international firm launched a new product during 2005 containing Tyrostat™. We first provided Tyrostat™ samples to this company in 1997! We are proud to see industry leading brand names such as Johnson & Johnson using our actives and highlighting them in their advertising and on their packaging. A broad range of industry leaders as well as many smaller companies around the globe now use our actives to create natural, efficacious solutions to everyday needs.

Highlights of the year 2005 include:

- The lowest ever production costs late in the year thanks to our continued review of processing and quality control systems. We have confidence that we can fully satisfy our customers' requirements.
- Continued sales growth of 16% over 2004 and an average 18% annually since the year 2000.
- Development of alternate product formats to provide formulation flexibility; and,
- The signing of an agreement with a partner in India aimed at obtaining approval for the use of our actives in their pharmaceutical products.

Cash flow continues to require careful management and at times forces us to make business decisions driven by cash position more than profitability. This challenge, combined with weather conditions in the spring of 2005 that made raw material harvesting difficult, forced us to do some smaller processing runs which resulted in a higher than normal average cost of sales. But these smaller processing runs allowed us to test some substantial efficiency improvements which resulted in the lowest cost individual process runs ever made, late in the year.

Our sales are truly International in nature. As such, the predominant currency of commerce is the US dollar. The continued strength of the Canadian dollar has the effect of increasing the cost of our ingredients to our customers and/or making them less price competitive as compared to some competing products from other countries. In spite of this, we are seeing continued sales growth averaging 18% per year. Future currency shifts are difficult to predict, but it is likely that the strength of the Canadian dollar, or at least the rate of increase in the value of the Canadian dollar will soften, making potential further cost increases to our customers unlikely. A softer Canadian dollar increases the potential for further sales growth.

During 2005, sales of Tyrostat™, our skin-lightening active, increased sharply. The growth in Tyrostat™ sales confirms the functionality and market demand for this multifunctional skin-lightener. Sales of Canadian Willowherb™ were soft late in the year as a result of inventory adjustments and delays in orders and launches of some new products by the cosmetic industry during Q4. Sales momentum recovered early in 2006. I continue to be excited about the wide variety of new product trials being done globally using this proven multi-efficacy natural active.

Personal care consumers have a growing appetite for effective, functional, natural ingredients. They are increasingly recognizing the synergistic impact of multifunctional whole extracts compared to the activity of single molecule synthetics. Concerns about exposure to environmental pollutants continue to fuel a steady shift to natural ingredients which are perceived as safe. Consumers continue to demand greater efficacy and quality in their consumer goods and formulators demand the same in their product ingredients. The market has become increasingly concerned about the use of preservatives in both ingredients and final products, while consumers demand greater product safety and long shelf-life products.

Our response to this environment has been to develop differentiated product formats that will allow our customers more flexibility to use our ingredients. More product options strengthen the market opportunity for both our current products and new products.

All of these trends provide opportunities for us to improve, reformulate and repackage our existing ingredients, and to discover new solutions to our customers' requirements. Improvements to our existing products and processes allow us to meet these changing demands.

The Canadian natural health product industry is going through some changes to the regulatory environment aimed at ensuring the safety and efficacy of all products sold. We welcome the changes as they should better protect the consumer, improve the acceptance of our products, and the wide variety of consumer products using our actives. Because of our interest in the development of new regulations, I have taken the opportunity to provide input throughout this process. Our focus on product improvement over the past several years has positioned us to continue to grow in this changing environment.

Our strategy is to rely on growth through a combination of product support, improvements and enhancements providing opportunity for increased market penetration, and generating positive cash flow to provide for new product development. We continue to use strategic partnering supported by in-house initiatives as a marketing formula in the personal care sector, and rely mainly on company activities in other target market sectors.

I am enthusiastic about the promise and potential of the year ahead.

Sincerely,

Art Hesje
President & Chief Executive Officer









Management's Discussion & Analysis of Financial Condition and Results of Operations

The following analysis outlines the Company's results of operations, financial condition and cash flows. The following discussion should be read in conjunction with the audited financial statements and accompanying notes prepared in accordance with Canadian Generally Accepted Accounting Principles (GAAP). This discussion and analysis may include some forward-looking statements that may differ materially from actual results that will be achieved.

SELECTED FINANCIAL INFORMATION FOR THE YEARS ENDED DECEMBER 31,

	2005	2004	2003	2002	2001	2000
		Restated	*Restated*			
Sales	**$ 654,478**	**$ 562,694**	**$ 577,429**	**$ 546,570**	**$ 522,755**	**$ 289,176**
Cost of goods sold	306,346	194,166	181,466	168,435	181,114	93,983
Gross Margin	348,132	368,528	395,963	378,135	341,641	195,193
Other Income	10,033	11,222	50,639	55,432	91,667	140,008
Gross Income	**358,166**	**379,750**	**446,602**	**433,567**	**433,308**	**335,201**
Operating Expenses	587,474	588,858	850,607	1,013,833	1,105,179	1,164,024
EBITDA (Operating Income) (Non-GAAP measure)	**(229,309)**	**(209,108)**	**(404,005)**	**(580,266)**	**(671,871)**	**(828,823)**
Net Marketing Agreement Revenue (MAR)	-	296,715	317,752	28,831	-	-
Net (Loss) Income after MAR	(229,309)	87,607	(86,253)	(551,435)	(671,871)	(828,823)
Other Expenses (Income)						
Depreciation	35,311	38,890	42,874	42,131	43,904	35,775
Stock Compensation Expense	30,017	18,914	(2,422)	-	-	-
Gain on Ext. of Old Debt	(9,197)	-	-	-	-	-
Accretion of Disc. on Conv. Debt	18,313	2,936	18,108	4,078	22,219	-
Dividend Interest relating to Preferred Share Liability	26,092	21,488	35,683	-	-	-
Total other expenses	100,536	82,228	94,243	46,209	66,123	35,775
Net (Loss) Income	(329,845)	5,379	(180,496)	(597,644)	(737,994)	(864,598)
Gross Margin as a % Sales	**53.2%**	**65.5%**	**68.6%**	**69.2%**	**65.4%**	**67.5%**
Operating Expenses per $ Sales	**0.90**	**1.05**	**1.47**	**1.85**	**2.11**	**4.03**
EBITDA as a % Sales	**-35%**	**-37%**	**-70%**	**-106%**	**-129%**	**-287%**

This table provides a reconciliation of EBITDA to the Company's Net (Loss) Income as reported in the Statements of (Loss) Income and Deficit.

NON-GAAP MEASURES

Securities regulators require that issuers caution readers that measures adjusted to a basis other than generally accepted accounting principles (GAAP), do not have standardized meaning under GAAP and are unlikely to be comparable to similar measures used by other companies. Changes in accounting policies make year to year comparisons difficult using the accepted normal accounting terms. To compare operating performance year to year and to provide understanding regarding the future operations of the Company, a variety of non-GAAP terms are used in the table above. Fytokem uses EBITDA (Earnings Before Interest (non-cash), Taxes, Depreciation and Amortization), a non-GAAP measure. EBITDA is presented solely as a supplemental disclosure because management believes it provides useful information regarding operating performance. We define EBITDA as operating (loss) income or net (loss) income before depreciation, amortization, stock-based compensation, allowance for dividend interest on Series A Preferred Share liability, accretion on debenture and non-cash gain on settlement of liability component of the convertible demand loan.

Operating expenses include all expenses relating to marketing, product development and finance & administration. Other income includes project revenue, miscellaneous and interest income.

OVERVIEW

Fytokem Products Inc. develops and delivers proven natural ingredients to leading formulators in the personal care, nutraceutical and pharmaceutical industries.

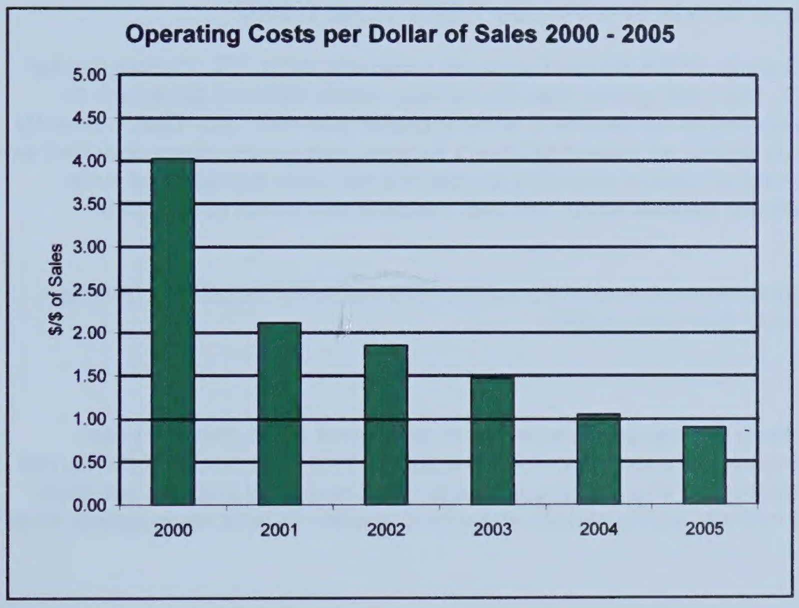
2005 highlights include the following:

- Record product sales at 16% higher than in 2004, continuing an annual compound growth rate of 18% over the past five years.
- A reduction of 14% in operating expenses per dollar of sales. Growth in sales and control of operating expenses combined to reduce the operating expenses per dollar of sales revenue to $0.90, a decline of 14% from the $1.05 in 2004. This is an all time best for this performance measure and the first time it has fallen below $1.00.

OPERATIONS

Our activities in fiscal 2005 were focused on sales growth, improving our product quality, quality control systems and operating efficiencies to improve both short and long term profitability. Limited cash resources and a difficult growing season caused a shortage of raw material early in the year, which required a series of relatively small processing runs producing substantially higher unit processing costs. While these increased processing costs reduced the gross margin on sales in 2005, it provided the opportunity for a variety of process improvements that resulted in sharply reduced processing costs late in the year. We expect the beneficial effects of these changes to show in 2006 and beyond.

RESULTS OF OPERATIONS



One measure of operating performance is the ratio of operating expenses incurred per dollar of sales. Growing sales combined with tight control of operating costs resulted in these costs being reduced to $0.90 per dollar of sales revenue from $1.05 in 2004. This measure of operating performance has declined dramatically from $4.03 in 2000.

In spite of this improvement, the Company experienced a loss of $329,845 or ($0.02) per share in 2005. As of December 31, 2005 the Company's working capital deficit, current assets less current liabilities, was $670,107; $321,141 greater than the working capital deficit at December 31, 2004. Changes in accounting policies made a significant contribution to this decline in working capital. The net decrease in cash during the year was $13,810. Total assets were $292,172, $113,357 lower than at December 31, 2004. The capital deficiency amounted to $922,495, which includes an accumulated deficit of $4,965,438.

REVENUES

Product sales increased 16% over 2004 to $654,000, continuing the growth trend of recent years. This growth in sales has occurred in spite of a strengthening Canadian dollar which increases the cost of our products to some foreign customers. While product sales revenue increased in 2005, total revenue was 28% lower than in 2004, which was the final year in which marketing agreement revenue was recognized as a result of $750,000 received in 2002. The Company reported no project revenue in 2005, but did record other revenue of $10,033 and a non-cash gain on the settlement of the original convertible demand loan. Other revenue, which is comprised of one-time revenue items plus interest revenue, fluctuates annually.

There was no project revenue in 2005 as compared to $5,689 in 2004, as a result of no participation in government-sponsored programs.

While product sales increased in 2005, gross margin decreased to 53.2% from 65.5% recorded in 2004, due to increased production costs associated with smaller volume process runs. These, in turn, were caused by tight cash flows and spring weather conditions that created a number of raw material supply challenges. On the other hand, efficiencies realized from process improvements and larger volume production runs near yearend 2005 produced the lowest processing and inventory costs the

Company has ever achieved. The benefit of these process cost improvements will be realized on sales in 2006. Depending on the product sales blend, a target gross margin of 65-70% should be achieved.

OPERATING EXPENSES

Product development expenses for the year showed an 8% reduction as a result of general cost reductions in all product development areas. Expenditures in this area are expected to continue at the current level.

Marketing expenses were 44% less than in 2004. This reduction is the direct result of no marketing agreement expense in 2005, relating to the associated marketing agreement which was fully amortized by the end of 2004. Finance and administration costs in 2005 represent a 9% increase over last year due to increased expenses related to investor relations, regulatory reporting and professional fees.

Total operating expenses were essentially the same as last year.

LIQUIDITY AND CAPITAL RESOURCES

Since inception, the Company has financed its operations and capital expenditures primarily through equity offerings, long term debt and, to a lesser extent, third-party (including government-sponsored) research grants and marketing agreement revenues. For the past few years, product sales have contributed significantly to the Company's cash flows, thereby reducing the reliance on external sources of capital.

In addition to strong cost control throughout the year and strong sales growth, the Company had significant transactions that affected its cash balance for the year ended December 31, 2005. Investment Saskatchewan Inc. (ISI) agreed to refinance its $275,000 debt at a more attractive interest rate, with repayment of principal to begin January 1, 2006. The Agri-Food Equity Fund also agreed to defer the principal payment of $50,000 due on its debenture from July 1, 2005 to July 1, 2006.

At December 31, 2005, Fytokem had cash and cash equivalents of $35,860 and accounts receivable of $1,675. Working capital deficit, current assets less current liabilities, was $670,107, $321,141 greater than the working capital deficit at December 31, 2004. Accounting policy changes account for approximately half of this decline in working capital year over year. Due to recently mandated changes to accounting policies and classification of debt, all loans that have a demand feature have been classified as short term or current debt, even though there are set payment schedules extending beyond the next year and demand is not expected. Restating working capital in terms of what is actually payable within one year makes a substantial difference to effective working capital.

Informational Note *– Recent changes to accounting policies have a substantial impact on the method of calculating working capital, making it a less comparable measure of a Company's financial condition.*

INFLATION, RISK AND FOREIGN EXCHANGE

The impact of inflation on the Company's operations has been minimal and is expected to be minimal in the next few years. Substantially all sales transactions are now, and will continue to be, denominated in Canadian Dollars. The foreign currency risk experienced by the Company relates to changes in the relative cost of competing products. The Company's products are more price competitive and sales growth is more likely in some markets, during periods when the Canadian dollar is weak against other currencies, particularly the US dollar.

INTELLECTUAL ASSETS

As Fytokem is a knowledge-based company, many of its greatest assets do not appear on the balance sheet. These assets include our proprietary know-how and intellectual property which include certain patents, corporate and product trade marks, product registrations, confidential disclosure agreements with corporate, academic and institutional bodies, and proprietary processes and manufacturing systems. These assets comprise a significant portion of the foundation of our present success and future potential. Most importantly, our small and loyal staff comprises a multidisciplinary array of scientific, technical, marketing, and business skills essential to build a dynamic enterprise. The blending of these skills make the business model work.

DISCLOSURE CONTROLS AND PROCEDURES

Management and the Board are committed to the promotion of investor confidence by ensuring that trading in the Company's securities takes place in an efficient, competitive and informed market. In accordance with the continuous disclosure requirements under the securities commission rules and TSX Venture Exchange policies, the Company has adopted a Corporate Disclosure Policy and has procedures in place to ensure that any sensitive information is identified, reviewed by management and disclosed in a timely manner to the regulatory authorities, shareholders and the public. The President and CEO of the Company has evaluated the Company's disclosure controls and procedures relating to the information required to be prepared and disclosed as at December 31, 2005, and has concluded that these controls and procedures were effective.

Although the Company's growing sales revenue is expected to fund its finance, administration and basic quality control functions, the Company is not entirely confident that its existing capital resources, plus anticipated cash flows from operations, will be adequate to satisfy its anticipated cash requirements for the next 12 months. The Company expects that it will be necessary to further reduce its expenditures and/or seek additional debt, debt restructuring or equity financing in the near future. It should be noted that if financing is not available to the Company on favorable terms, this may severely affect the Company's continued growth.

FORWARD LOOKING STATEMENTS

This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements concerning the Company's activities and prospects in future periods. All statements other than statements of fact may be deemed forward-looking statements. Forward-looking statements frequently, but not always use the words "expects", "anticipates", "suggests", "plans", "believes" or "intends", or similar words and/or include statements concerning the Company's strategies, goals and plans, or state that certain actions, events or results "will" be taken, occur or be achieved. These forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause the results, performance or achievement of the Company, or industry results, to be materially different from any future results, performance or achievements expressed or implied by such statements. Such factors include, among others: uncertainties related to early stage of development, technology and product development; dependence on future corporate collaborations; dependence on proprietary technology and uncertainty of patent protection; management of growth; future capital needs and uncertainty of additional funding; intense competition; manufacturing and market uncertainties; government regulation; product liability exposure and insurability. These and other factors are described in detail in the Company's reports, releases and other information filed with the Saskatchewan, Alberta and B.C. Securities Commissions. Forward-looking statements are based on current expectations and Fytokem Products Inc. is not obligated to update such information to reflect later events or developments.

Management's Responsibilities for Financial Reporting

The accompanying financial statements of Fytokem Products Inc. are the responsibility of management and have been approved by the Board of Directors.

Management in conformity with Canadian generally accepted accounting principles has prepared the financial statements. The financial statements include some amounts that are based on best estimates and judgments. Financial information used elsewhere in the annual report is consistent with that in the financial statements.

The management of the Company, in furtherance of the integrity and objectivity of data in the financial statements, has developed and maintains a system of internal accounting controls. Management believes the internal accounting controls provide reasonable assurance that financial records are reliable and form a proper basis for preparation of financial statements and that assets are properly accounted for and safeguarded.

The Board of Directors carries out its responsibility for the financial statements in this annual report principally through its audit committee, consisting entirely of outside directors. The audit committee reviews the Company's annual financial statements and recommends their approval to the Board of Directors. The shareholders' auditors have full access to the audit committee, with and without management being present.

The shareholder's auditors, Deloitte & Touche LLP, Chartered Accountants, in accordance with Canadian generally accepted auditing standards, have examined these financial statements and their independent professional opinion on the fairness of the financial statements is attached.

"Art Hesje"

Art Hesje

President & Chief Executive Officer

Auditors' Report

To the Shareholders of Fytokem Products Inc.

We have audited the balance sheets of Fytokem Products Inc. as at December 31, 2005 and 2004 and the statements of (loss) income and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2005 and 2004 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

"Deloitte & Touche LLP"

Chartered Accountants

Saskatoon, Saskatchewan

April 7, 2006

Fytokem Products Inc. | Statements of (Loss) Income & Deficit

	Years Ended December 31, 2005	2004 Restated
REVENUE		
Sales (Note 15)	$ 654,478	$ 562,694
Cost of sales	306,346	194,166
Gross margin	348,132	368,528
Project revenue (Note 16)	-	5,689
Marketing agreement revenue (Notes 12 and 17)	-	360,000
Other revenue	10,033	5,533
Gain on settlement of principal component of convertible demand loan (Note 8(b))	9,197	-
	367,362	739,750
EXPENSES		
Product development	158,899	172,673
Marketing	78,170	140,388
Finance and administration	306,259	280,171
Depreciation	35,311	38,890
Interest on long term debt	44,146	61,847
Dividend interest on Series A Preferred Shares (Note 4)	26,092	21,488
Accretion on convertible demand loan (Note 8(b))	18,313	-
Stock compensation expense (Note 10)	30,017	18,914
	697,207	734,371
NET (LOSS) INCOME	(329,845)	5,379
DEFICIT, BEGINNING OF YEAR (as previously reported)	4,573,841	4,602,136
Change in accounting policy (Note 4)	61,752	38,836
DEFICIT, BEGINNING OF YEAR (as restated)	4,635,593	4,640,972
DEFICIT, END OF YEAR	$ 4,965,438	$ 4,635,593
BASIC AND DILUTED (LOSS) INCOME PER SHARE (Note 14)	$ (0.02)	$ 0.00

See accompanying notes.

	As at December 31, 2005	As at December 31, 2004 Restated
CURRENT ASSETS		
Cash	$ 35,860	$ 49,670
Accounts receivable (Note 16)	1,675	145,475
Inventories (Note 5)	192,345	114,347
Prepaid expenses	710	6,165
	230,590	315,657
DEFERRED FINANCE CHARGES (Note 4)	4,344	2,819
CAPITAL ASSETS (Note 7)	57,238	87,053
	$ 292,172	$ 405,529
CURRENT LIABILITIES		
Accounts payable and accrued liabilities	$ 384,760	$ 225,664
Accrued liability relating to Series A Preferred Shares (Note 4)	83,263	57,171
Current portion of long term debt (Note 8)	432,674	381,788
	900,697	664,623
LONG TERM DEBT (Notes 4 and 8)	313,970	394,416
	1,214,667	1,059,039
CAPITAL DEFICIENCY		
Common Shares (Note 9)	3,866,999	3,866,999
Equity portion of convertible demand loan (Note 8(b))	56,683	63,984
Contributed surplus (Note 11)	119,261	51,100
Deficit	(4,965,438)	(4,635,593)
	(922,495)	(653,510)
	$ 292,172	$ 405,529

See accompanying notes.

APPROVED BY THE BOARD

"Peter Oliver"
Peter Oliver, Director

"John Cross"
John Cross, Director

Fytokem Products Inc. | Statements of Cash Flows

	Years Ended December 31, 2005	2004 Restated
CASH FLOWS FROM (USED IN) OPERATING ACTIVITIES		
Net (loss) income	$ (329,845)	$ 5,379
Items not affecting cash		
Depreciation	35,311	38,890
Amortization of deferred marketing costs	-	63,285
Non-cash interest expense (Note 4)	2,419	7,781
Non-cash accretion expense	18,313	-
Non-cash stock compensation expense	30,017	18,914
Gain on settlement of principal component of convertible demand loan (Note 8)	(9,197)	-
	(252,982)	134,249
Changes in non-cash working capital		
Accounts receivable	143,800	(73,284)
Inventories	(77,998)	94,277
Prepaid expenses	5,455	6,022
Accounts payable and accrued liabilities	159,096	80,053
Accrued liability relating to Series A Preferred Shares (Note 4)	26,092	21,488
Deferred marketing revenue (Note 12)	-	(360,000)
	3,463	(97,195)
CASH FLOWS USED IN INVESTING ACTIVITIES		
Acquisition of equipment	(5,498)	(535)
CASH FLOWS (USED IN) FROM FINANCING ACTIVITIES		
Proceeds from issuance of common shares	-	125,000
Costs of share issuance	-	(3,950)
Costs of refinancing (Note 8(b))	(4,991)	-
Repayment of long term debt	(6,784)	(26,928)
	(11,775)	94,122
NET DECREASE IN CASH DURING THE YEAR	(13,810)	(3,608)
CASH POSITION, BEGINNING OF YEAR	49,670	53,278
CASH POSITION, END OF YEAR	$ 35,860	$ 49,670
REPRESENTED BY:		
Cash	$ 35,818	$ 49,628
Short-term investments	42	42
	$ 35,860	$ 49,670
SUPPLEMENTAL INFORMATION		
Cash interest paid	$ 40,142	$ 46,078

See accompanying notes.

1. **DESCRIPTION OF BUSINESS**
Fytokem Products Inc. (the Company) was incorporated under The Business Corporations Act of Saskatchewan on March 25, 1994. Fytokem Products Inc. is engaged in the discovery and commercialization of novel Function-Certified™ plant-based substances — extracts, phytochemicals and bioactive molecules — for use as ingredients in personal care, nutraceutical, pharmaceutical and bio-industrial products.

2. **BASIS FOR PRESENTATION**
The financial statements have been prepared in accordance with Canadian Generally Accepted Accounting Principles (GAAP) on a going concern basis, which presumes the realization of assets and discharge of liabilities in the normal course of business for the foreseeable future.

The Company, during its development stage, has incurred significant losses. The Company's ability to continue on as a going concern is dependent upon achieving profitable operations and possibly additional financing. The outcome of these matters cannot be determined at this time.

These financial statements do not contain any adjustments to the amounts and classifications of assets and liabilities that might be necessary should the Company be unable to continue its business.

3. **ACCOUNTING POLICIES**
The financial statements have been prepared in accordance with GAAP and include the following significant accounting policies:

(a) Use of Estimates
The preparation of these financial statements in conformity with GAAP requires management to make estimates and assumptions that affect reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from those estimates. Significant areas requiring the use of management estimates relate to the useful lives of depreciable assets used to compute depreciation, the valuation of stock options and the valuation of convertible debt.

(b) Inventories
Inventory consists of raw materials, work-in-progress and finished goods. Inventories are recorded at the lower of cost and estimated net realizable value. Cost is determined on an average cost basis and includes direct materials and processing costs. There are no allocations of internal labour and overhead costs included in these cost values.

(c) Capital Assets
Equipment is recorded at cost. The cost of additions, and where useful lives are significantly extended, betterments and renewals are capitalized. Repairs and consumable supplies are expensed as incurred.

Depreciation is computed using the straight-line method at rates estimated to depreciate the cost of the assets over their useful lives.

The Company periodically assesses the depreciation period and recoverability of the carrying amount of its equipment to determine potential impairment.

(d) Fair Value
The fair value of financial instruments are generally determined as follows:

Financial instruments included in current assets and current liabilities are all short term in nature and as such, their carrying value approximates fair value.

The fair value of the long term debt with fixed rates of interest are estimated using discounted cash flows based on current rates of interest for similar lending arrangements.

Unless otherwise disclosed in the notes to financial statements, the fair value of an instrument approximates its carrying value.

(e) Deferred Finance Charges
Deferred finance charges relate to the costs of issuance of the convertible debt, preferred share liability and debentures and are being amortized on a straight-line method over the term of each debt instrument.

(f) Deferred Marketing Costs
The incremental, direct costs of establishing and setup of the Cooperation and License Agreement (Marketing Agreement) (note 17) have been deferred and amortized over the same period as the corresponding revenue has been realized.

(g) Revenue Recognition
Revenue includes product sales, project revenue and marketing agreement revenue. Revenue on sales of product is recognized when the goods are sold. Project revenue is recognized over time as the projects are completed.

Revenue related to the marketing agreement (note 17) had been deferred and recognized on a straight-line basis over the period December 1, 2002 through December 31, 2004. The Company had determined this period to be the period with firm purchase commitments and firm pricing.

(h) Government Assistance
The Company makes periodic applications for financial assistance under available government incentive programs for project funding and Scientific Research and Experimental Development (SR&ED) tax credits. Government funding for research and development projects is recorded as revenue in the period the related expenditures are incurred, and SR&ED tax credits relating to non-capital expenditures are recorded as a reduction of expenses when the related expenditures are incurred.

(i) Research and Development
Research costs, including research performed under contract by third parties, are expensed as incurred. Development costs, including direct legal and other costs related to patents, are also generally expensed as incurred unless such costs meet the criteria under GAAP for deferral and amortization. To date, no development costs have been deferred.

(j) Stock-Based Compensation and Other Stock-Based Payments
Effective January 1, 2002, the Company adopted the CICA Handbook (HB) Section 3870 "Stock-based Compensation and Other Stock-based Payments", which established standards for the recognition, measurement and disclosure of stock-based compensation and other stock-based payments made in exchange for goods and services. HB 3870 sets out a fair value based method of accounting that is used for all stock-based compensation.

(k) Future Income Taxes
The Company follows the asset/liability method of accounting for income taxes. Under this method, future income taxes are determined based on the difference between the carrying value of assets and liabilities and their tax basis using the tax rates expected to be in effect when the asset or liability is settled.

4. CHANGE IN ACCOUNTING POLICY
In January 2004, the CICA issued amendments to Handbook Section 3860 "Financial Instruments-Disclosure and Presentation". The amendments require that contractual obligations which can be settled at the holder's option by issuing a variable number of the issuer's own equity instruments, be presented as liabilities rather than equity. Dividend payments arising from such financial instruments will be treated as an expense within the statements of income. This change in accounting policy has been applied retroactively. The amended standard has required the re-classification of the Company's Series A Preferred Shares that are convertible into common shares at the option of the holder, as a liability, rather than as equity, within the balance sheets.

Series A Preferred Shares, which previously had been reported as a shareholder's equity valued at $244,221 ($250,000 less $5,779 of legal costs related to financing) will now be presented as a liability of $250,000 retroactively, with the legal costs set up as a deferred finance charge to be recorded as an interest expense over time. The net effect of this accounting change at January 1, 2004 is an increase in opening deficit of $38,836, which estimates the potential accumulated dividend and penalty interest expense of $35,683 and $3,153 financing costs included in interest on long term debt (pre-2004 portion of $5,779 initial legal costs related to financing). At December 31, 2004 the net increase to deficit of $22,916 relates to potential accumulated dividend and penalty interest expense of $21,488 and $1,428 financing costs on long term debt (2004 portion of $5,779 initial legal costs related to financing). As a result, dividend interest has increased by $21,488, interest on long term debt increased by $1,428, accrued liabilities relating to Series A Preferred Shares have increased by $57,171, deferred financing charges increased by $1,197, long term debt has increased by $250,000 and share capital decreased by $244,221. During 2005, the increase in net loss due to this change is $26,920, which consists of $26,092 of potential dividend and penalty interest included as dividend interest expense, an increase in accrued liabilities relating to Series A Preferred Shares of the same and the 2005 portion of deferred finance charge of $828 included in interest on long term debt.

5. INVENTORIES

	2005	2004
Raw materials	$ 33,459	$ 69,417
Finished goods	158,886	37,459
Work in progress	-	7,471
	$ 192,345	$ 114,347

6. DEFERRED MARKETING COSTS

	2005	2004
Opening balance	$ -	$ 63,285
Less: Amortization	-	(63,285)
Ending balance	$ -	$ -

7. CAPITAL ASSETS

	Estimated Life	2005 Cost	2005 Accumulated Depreciation	2004 Cost	2004 Accumulated Depreciation
Furniture and fixtures	8 years	$ 50,268	$ 45,163	$ 50,268	$ 40,131
Computers and office automation	4 years	98,547	86,835	94,678	79,636
Lab equipment	8 years	190,844	150,423	189,216	127,342
		339,659	$ 282,421	334,162	$ 247,109
Less accumulated depreciation		(282,421)		(247,109)	
		$ 57,238		$ 87,053	

Included in the above cost figures are assets under capital leases as follows:

	2005	2004
Computers and office automation	$ 10,337	$ 10,337

8. LONG TERM DEBT

	2005	2004 Restated
Convertible demand loan (ISI)	$ 275,000	$ 275,290
Debenture (AFEF)	256,770	260,148
Series A Preferred Share liability (AFEF)	250,000	250,000
Capital lease obligations	4,292	7,410
	786,062	792,848
Equity portion of convertible demand loan	(39,418)	(16,644)
	746,644	776,204
Less current portions	(432,674)	(381,788)
	$ 313,970	$ 394,416

Emerging Issues Committee Abstract -EIC 122 requires that the ISI convertible demand loan be reclassified and recorded as a current liability. The scheduled principal payments on all long-term debt are as follows:

2006	$ 295,174
2007	190,888
2008	50,000
No scheduled repayment	250,000
	$ 786,062

There are no scheduled repayment dates for the Series A Preferred Share liability of $250,000.

(a) General Security Agreement

The Toronto Dominion Bank holds a general security agreement of up to $75,000 related to the Company's corporate credit cards.

(b) Convertible Demand Loan (ISI)

On February 5, 1999 the Company received proceeds through a $500,000 convertible demand loan with monthly principal payments of $10,417 beginning April 1, 2001, and an original maturity date of January 31, 2005 from Saskatchewan Opportunities Corporation (SOCO). A series of amendments to this convertible demand loan have been agreed to with the effect of delaying principal payments and extending the maturity date to August 1, 2006. The convertible demand loan was secured by a general security agreement.

Effective October 8, 2002, SOCO agreed to assign and transfer its rights and obligations under the loan agreement with the Company to CIC Industrial Interests Inc. (CICIII), an affiliated crown corporation. Effective September 2, 2003 CICIII changed its name to Investment Saskatchewan Inc. (ISI). None of the terms or conditions were affected by these assignments.

ISI had the option at any time during the term of the loan to convert any portion of the outstanding balance of the loan to Common Shares of the Company. This option expired during the year. The Company could repay the convertible demand loan any time until maturity.

On July 29, 2005 an agreement was finalized to pay out the balance of this convertible demand loan and enter into a new financing agreement. The accounting treatment for the extinguishment of the old debt resulted in a total non-cash gain of $47,341, which was apportioned between the principal and equity components, based on their relative fair values . The gain of $9,197 on the principal component of the debenture is reflected in the Statement of (Loss) Income and Deficit and the balance of $38,144 is recorded as Contributed Surplus (note 11).

The net effects of refinancing $275,000 are as follows:

- Interest continues to be paid monthly, with the interest rate being reduced from 12% to a floating rate of prime plus 2%, with a minimum rate of 7%. The interest rate actually paid under this new convertible demand loan in 2005 was 7%.
- Repayment is scheduled as 24 equal monthly principal payments of $11,458, beginning January 1, 2006.
- The term of the loan was extended to December 1, 2007, with the same security as the original agreement.
- Conversion privileges were given for five years from the date of advancement, at a fixed conversion price of $0.10 per common share over the first two years, as in the original agreement. Beyond the first two years, the conversion price increases at a minimum of 10% per year as allowed by the TSX-Venture.
- The Company issued 275,000 warrants with an exercise price of $0.19 per common share (note 9(c)). These warrants could lead to a further injection of equity investment in the future.

In addition, the new convertible demand loan contains both a liability and an equity element represented by possible conversion of the outstanding balance of the loan into common shares and therefore under GAAP, these two elements must be split and classified separately as debt and equity. The following non-cash entries were made to extinguish the original debt and set up the new loan:

- The new convertible demand loan was set up as $217,269 and the equity component was $57,731, due to the granting of warrants and extending conversion privileges. The discount of $57,731 will be accreted over the term of the loan. To December 31, 2005, $18,313 was recorded as accretion expense on convertible demand loan. The balance of the discount at year end was $39,418.
- Legal costs related to the financing totaling $4,991, were proportionately recorded as $3,943 Deferred Finance Charges, allocated to debt and $1,048 against the equity portion, leaving a net equity amount of $56,683.

(c) Classification of Liability and Equity Components of Convertible Debt

The Company has assigned carrying amounts to the liability and equity elements of the financial instruments discussed in Note 8(b) above, in accordance with the substance of the contractual arrangement. The Company had determined the carrying amount of the financial liability of the old convertible debt by discounting the stream of future cash payments of interest and principal at an estimated market rate of 20% for a similar liability that does not have an associated equity component. The carrying amount of the equity component of the convertible demand loan was $63,984. On July 29, 2005, this demand loan was repaid and a new convertible demand loan was entered into.

The Company has allocated the total proceeds received from the new convertible demand loan to the liability and equity components, proportionately, based on their respective fair values. The Company has determined the carrying amount of the financial liability of the new debt discussed in Note 8(b) by discounting the stream of future cash payments of interest and principal at an estimated market rate of 12%, which was the rate of the old loan (without warrants and conversion privileges expired). The fair value of the warrants were valued at $0.012 per common share using the Black-Scholes method with an assumed 50% volatility, plus other assumptions (see table below) and the fair value of the conversion feature at $0.036 per share also using the Black-Scholes method with assumed 50% volatility, plus other assumptions (see table below). These two equity values were then averaged to arrive at an estimated equity portion of the loan. The net effect is to record an interest related expense calculated at 24.7% based on the assumption that this would be the expense for a similar liability that does not have an associated equity component. Actual interest paid on this liability is a floating rate of bank prime plus 2% with a minimum overall rate of 7%.

	Warrants	Conversion Feature
Stock price at grant	$0.105	$0.105
Exercise price	$0.19	$0.10
Expected dividend yield	$0.00	$0.00
Expected volatility (assumed)	50%	50%
Risk-free interest rate	2.60%	2.60%
Expected life	2 years	2.42 years
Fair Value used in calculation	$0.012	$0.036

The convertible demand loan discussed in Note 8(b) has been classified as a current liability as a result of the demand feature contained in the security documents which allow ISI to demand payment at any time. No demand for payment has been made, nor is any demand anticipated.

(d) Debenture (AFEF)
On May 15, 2002, the Company received $250,000 from the Agri-Food Equity Fund (AFEF) in the form of a debenture due July 1, 2007. Interest is payable on a formula of 6% fixed rate plus 6% of net income before income taxes. Interest up to and including June 30, 2003 was added to the principal balance at that date. Annual payments of principal and interest were to begin on July 1, 2003. In 2003, AFEF agreed to postpone the July 1, 2003 principal payments to July 1, 2007 and the July 1, 2004 principal payment to July 1, 2005. This debenture is collateralized by a general security agreement. Since that time, the Agri-Food Equity Fund has agreed to again postpone principal payments, with $150,000 due July 1, 2006 and $100,000 due July 1, 2007.

Prepayment of the debenture is permitted, subject to an earned interest rate to the Agri-Food Equity Fund of 15% per year.

(e) Series A Preferred Share Liability (See Note 4)

Date		Shares Issued	Net Proceeds Restated
December 31, 2004 (restated) & 2005	Series A Preferred Shares	250,000	$ 250,000

The holders of the Series A Preferred Shares (limited to 400,000) are entitled to a cumulative fixed annual 6% dividend and to a participating dividend of 6% of net income, subject to certain restrictions. These shares are redeemable at the option of the Company, with one-third of the shares redeemable each year, commencing in January 2005, and are convertible to Common Shares (at the 60 day average market price less the maximum discount allowed by the stock exchange) by the holder subsequent to the redemption date for such shares. The cumulative fixed annual dividend rate becomes 10% in the event the Company does not redeem shares when available and these shares are not converted to Common Shares by the holder.

Cumulative dividends including participating dividends on these shares to December 31, 2005 are $68,154 (2004: $49,821). These dividends have not been declared or paid. Unpaid fixed annual dividends are subject to a 15% interest rate. The unpaid participating dividends are also subject to a 15% interest rate, subject to certain restrictions. Penalty interest accrued on undeclared dividends to December 31, 2005 is $15,109 (2004: $7,350).

(f) Lease Obligations
The capital lease obligation is at a fixed rate of 13.78%. The operating lease obligations are primarily for the Company's rented office and lab space at its head office in Saskatoon.

Minimum lease payments are as follows:

	Capital leases	Operating leases
2006	$ 4,292	$ 23,024
2007	-	23,701
2008	-	12,020
	$ 4,292	$ 58,745

9. SHARE CAPITAL

a) Authorized
Unlimited number of Common Shares without nominal or par value and an unlimited number of Preferred Shares (see Notes 4 and 8(e)).

b) Common Shares

Date		Common Shares Issued	Net Proceeds
December 31, 2004 & 2005	Balance	17,863,121	$ 3,866,999

c) Warrants
A summary of warrant activity and information concerning currently outstanding and exercisable warrants is as follows:

		Warrants Outstanding	
Date		Number of Common Shares	Weighted Average Exercise Price
December 31, 2004	Balance, beginning of year	500,000	$0.10
	Issued during year (Note 8(b))	275,000	$0.19
December 31, 2005	Balance, end of year	775,000	$0.13

d) Stock Option Plan

On June 30, 2000, a Stock Option Plan was approved by the shareholders of the Company, to provide the right and an incentive to employees, directors and other qualified parties to directly purchase equity in the Company. This incentive is meant to encourage continuing association with the Company, while providing the Company with additional investment capital.

The maximum number of shares which can be issued under the Stock Option Plan is 2,400,000 Common Shares. Notwithstanding the above, the maximum number of shares reserved for issuance to any one person upon the exercise of Options is limited to 5% of the total number of shares then outstanding.

	2005		2004	
	Number of Options	Weighted-Average Exercise Price	Number of Options	Weighted-Average Exercise Price
Balance, beginning of year	1,285,000	$0.15	750,000	$0.20
Granted	100,000	$0.10	650,000	$0.10
Expired	(110,000)	$0.40	(75,000)	$0.27
Forfeited	-	-	(40,000)	$0.10
Balance, end of year	1,275,000	$0.12	1,285,000	$0.15
Options exercisable at year end	875,000	$0.14	635,000	$0.20

	Options outstanding		Options exercisable
Range of exercise prices	Number of options	Weighted-average remaining contractual life (years)	Number of options
$ 0.10	920,000	3.51	520,000
0.13	185,000	.56	185,000
0.25	170,000	.12	170,000
Total	1,275,000	4.19	875,000

Options are exercisable by the holder based on a combination of both the performance conditions being met and the vesting conditions being met. The Options under this Stock Option Plan vest after the following time has passed from the grant date: 50% after six months; 25% after 12 months and 25% after 18 months.

10. STOCK-BASED COMPENSATION

CICA Handbook Section 3870 establishes a fair-value based method for accounting for stock-based compensation plans which the Company adopted in 2004 with retroactive effect to January 1, 2002.

For the year ended December 31, 2005, the Company has recorded a stock compensation expense of $30,017 (2004: $18,914) with an offsetting credit to contributed surplus (note 11) to reflect the estimated fair value of these transactions in 2005.

The fair value of each option grant is estimated as of the date of the grant using the Black-Scholes options pricing models. Option pricing models require the input of highly subjective assumptions including expected price volatility. Changes in the subjective input assumptions can materially affect the fair value estimates, and therefore existing models do not necessarily provide a reliable single measure of the fair value of the Company's stock options. There is no cash cost to the Company related to these options.

The following assumptions were used to calculate the fair value for stock option grants:

	Stock Options	
	2005	2004
Expected dividend yield	$0.00	$0.00
Expected volatility	137.1%	133.7%
Risk-free interest rate	3.40%	3.40%
Expected life of options	5 years	5 years
Fair Value of Option	$0.08	$0.09

Stock compensation expense is incurred on a pro-rated basis as the options vest and are earned. The Company accounts for forfeitures as they occur.

11. CONTRIBUTED SURPLUS

Prior to the refinancing with ISI (note 8(b)), all entries affecting contributed surplus were related to stock compensation expense. All entries relating to contributed surplus are non-cash items. Details of these items during 2005 are as follows:

	Contributed Surplus 2005	2004
Balance, beginning of year	$ 51,100	$ 2,186
Stock Compensation Expense (note 10)	30,017	18,914
Warrants issued in 2004	-	30,000
July 29, 2005 Equity portion of old ISI debt extinguished (note 8(b))	38,144	-
Balance, end of year	$ 119,261	$ 51,100

12. DEFERRED MARKETING REVENUE

	2005	2004
Opening balance	-	$ 360,000
Revenues recognized	-	(360,000)
Ending balance	-	$ -

13. INCOME TAXES

The Company has losses totaling $3,456,655 at December 31, 2005 (2004: $4,072,903) available to reduce future taxable income. The expiration dates for these losses are as follows:

2006	$ 931,497
2007	935,286
2008	688,261
2009	-
2010	560,673
2014	254,360
2015	86,578

Temporary differences, including the above losses, which would have given rise to a future tax asset balance, amount to $3,765,417 at December 31, 2005 (2004: $4,333,361). Other than the losses discussed above, these temporary differences can be carried forward indefinitely. The potential tax benefit of these items has not been reflected in these financial statements.

SR&ED tax credits of $130,309 in 2005 (2004: $147,186) are available to carry forward to the future years for offset against income taxes otherwise payable. The potential tax benefit of this has not been reflected in these financial statements.

The expiration date of these tax credits are as follows:

2006	$ 16,243
2007	5,049
2008	30,510
2009	38,188
2010	5,722
2011	12,180
2012	22,417

14. (LOSS) INCOME PER SHARE

Basic (loss) income per share is calculated on the weighted average number of shares issued and outstanding during the year ended.

Due to the fact that all potentially dilutive instruments issued and outstanding during each period are anti-dilutive, the diluted income (loss) per share is equal to the basic income (loss) per share for all periods. The weighted average number of shares outstanding in each of the periods are as follows:

Year ended December 31, 2005	17,863,121
Year ended December 31, 2004	15,794,628

15. ECONOMIC DEPENDENCE

During the year, the Company's sales were essentially all to one distributor (note 17).

16. GOVERNMENT ASSISTANCE

During the year, the Company recorded as project revenue, government assistance of $NIL (2004: $5,689). Of this amount, $NIL (2004: $NIL) was receivable at year end.

17. CONTRACTUAL OBLIGATIONS

a) Atrium Biotechnologies Inc.

The Company entered into a Cooperation and License Agreement with Atrium Biotechnologies Inc. (Atrium) of Quebec City, PQ on October 24, 2002, pursuant to which the Company granted to Atrium the sole and exclusive right to distribute and sell all of the Company's existing products, as well as other products that may be agreed upon from time to time, to the personal care and nutraceutical industries. The Company received $750,000 from Atrium for this right.

The Company recognized $Nil (2004: $360,000) in marketing revenue related to this agreement in the year.

The Company amortized $Nil (2004: $63,285) in costs related to this agreement in the year.

b) Revenue-Based Operating Lease with Saskatchewan Opportunities Corporation (SOCO)

The Company entered into a lease for its head office and laboratory space with SOCO effective July 1, 2004 through June 30, 2008. The Company received a substantial reduction in its fixed lease amount but committed to revenue based additional lease amounts with SOCO. All other conditions of the lease remained the same.

18. SUBSEQUENT EVENT

In February, 2006, 150,000 stock options were exercised at $0.10 per common share. The net proceeds of this transaction was $15,000.

19. COMPARATIVE FIGURES

Certain of the prior period's figures have been reclassified to conform to the current year's presentation.

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STOCK INFORMATION

TSX Venture Exchange

Stock Symbol:	FYT
Shares Outstanding:	18,013,121
2005 Share Price Range:	$0.19 to $0.08

AUDITORS

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THE ANNUAL MEETING OF SHAREHOLDERS WILL BE HELD ON

Friday, June 23, 2006 at 2:00 p.m.
Golden Room, 2nd Floor, Atrium Building
Innovation Place
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